A look at designing and implementing long-term pension investment mandates
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With any pension investment, plan sponsors must follow the same steps: set a policy, select asset managers and ensure strong governance, monitoring and evaluation.

Pension funds can take additional steps to better embed long-term principles throughout the entire investment cycle, according to a working paper by Alfred Slager, a professor of pension fund management at the TIAS School for Business and Society in the Netherlands and a trustee at the country's Pension Fund for General Practitioners, and Marcel Jeucken, a director at independent advisory firm SustFin.

When formulating their investment policy, pension funds should start by addressing why long-term investing is important, noted the paper.

As an example, the paper pointed to Spoorweg Pensioenfonds, the Dutch pension fund for railways, which embeds long-term investing in five of its 10 investment principles. Among these principles, the fund highlights the existence of a premium for illiquidity and investing in the long term, that valuations return to their long-term average and that sustainable and responsible investing can be done without harming the return-risk profile of the portfolio.

The next step is selecting an asset manager, which starts with designing a framework for the mandate and consists of developing an investment case and guidelines. "Once the investment guidelines are defined, the actual selection and development of a long-term mandate can take place," the paper said.

When plan sponsors are designing a long-term mandate, some considerations include which criteria will help them honour long-term promises, how to shape a collaborative relationship, how the manager shapes the engagement policy and the risk-return requirements.

In 2010, the Spoorweg Pensioenfonds launched a strategic equity portfolio with the aim to design a concentrated equity mandate that could achieve positive alpha in the long term, the paper said.
The portfolio was comprised of bottom-up companies with stable characteristics associated with revenue, profit and dividends from Europe, the U.S. and other developed markets. "The manager was not given a tracking error limit," noted the paper. "However, there is an implicit tracking error, because the total equity portfolio has a tracking error limit. This shows that the pension fund board integrally focuses on the entire portfolio and the long term."

After manager selection, pension funds must govern the mandate. This can include having explicit agreements to discuss the investment horizon that fits the risk-return profile and what this implies for the portfolio monitoring and evaluation, aligning fees with the long-term strategy and determining metrics for monitoring and evaluation, the paper noted.

"The benchmark deserves special attention concerning the governance of the mandate. It is important to agree upfront what the role of the benchmark is in monitoring and evaluation of the mandate. The benchmark must especially — from a principal agent problem — provide the board with insight into whether the manager is making consistent choices within the strategy."

Monitoring is another important part of a long-term investing process. “Ideally, the board has agreed or laid down in advance how it wants to deal with interim results in specific mandates,” said the paper. “How to employ and use benchmarks must explicitly be part of the board monitoring process and framework. Mutual trust and consistent behaviour are key words in this governance relationship.”

Governance also requires clarity about the investment time horizon, and the behavioural risks of the board which might affect that horizon and the board’s monitoring style.
For its strategic equity portfolio, the Spoorweg Pensioenfonds set a seven-year horizon for its evaluation and monitoring takes place annually. Also once a year, the portfolio’s managers discuss the portfolio in the pension fund board’s investment committee meeting. The board also receives quarterly reports, the paper added.

Monitoring is followed by evaluation. “When do you move from monitoring to evaluation? And how do you prevent that monitoring is more like evaluation than monitoring in practice? For long-term investing, it is very important to distinguish between these definitions and elements of the policy cycle.”

The paper outlined key elements for a thorough evaluation, including having a shared understanding of what should be evaluated, the time horizon for doing so and that continuing the strategy is the base case scenario and focusing on avoiding preventable surprises. “For example, conducting a pre-mortem exercise is a useful boardroom tool, which entails identifying potential problems and taking mitigating measures beforehand.”

For its strategic equity portfolio, the Spoorweg Pensioenfonds uses both a long-term absolute benchmark and a relative benchmark. “Over the investment cycle of this mandate a formal evaluation took place twice (in a duration of 11 years),” the paper said. “Looking towards the future, the evaluation will take place every three years. The evaluation is focused both on the quantitative as well as the qualitative key measures.”

These are just some of the many steps the paper suggested for pension funds to better embed long-term thinking in their investment process.

“For all pension schemes, the pension fund needs to generate investment results to fulfill the long-term pension commitments. For pension funds, that long-term horizon is both a natural advantage in comparison to other financial institutions, as well as a bitter requirement, especially in the current economic climate of low return expectations, where a limited extra return can quickly make the difference between cutting or indexing pension benefits.”

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